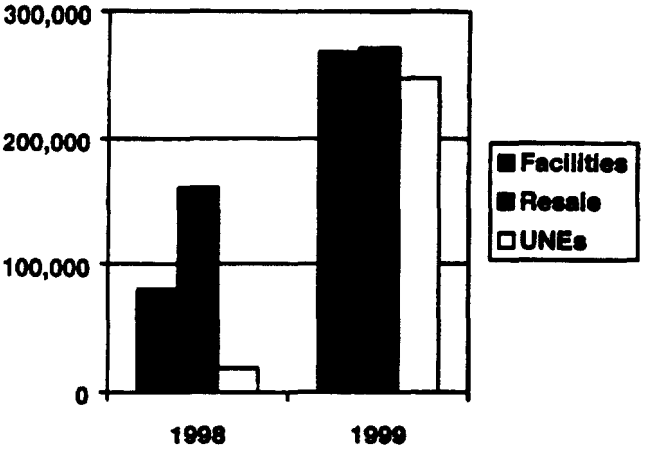
The FTA envisioned the entry of local exchange competitors through three avenues: facility-based, resale, and the purchase of unbundled network elements (UNEs). Figure 6 shows the manner in which CLECs provided service in Texas in 1998 and 1999. In 1999, CLECs appeared to use each of the three methods of entry in equal proportions.

Figure 6 – CLEC Method of Service Provision (Number of Loops)



COMPETITIVE ENTRY INTO TEXAS MARKETS

While CLECs have increased market share statewide, the data showed that CLECs were more successful in gaining market share in Large Metropolitan areas than in small metro or Rural areas. The comparison of the business and residential markets below indicates that CLECs penetrated business markets faster than residential markets in 1998 and 1999.

Business/Residential Comparisons

CLECs have been much more aggressive in gaining market share in local service for businesses than for residential customers. CLECs have twice the number of business lines than residential lines, as shown in Figure 7. While CLECs showed strong growth rates in both markets, by 1999 CLECs had ten percent of the lines that served business customers compared to only three percent of lines that served residential customers, as can be seen in Table 8 and Table 9. CLECs had a six percent market share of residential revenues, indicating that their revenues per residential line were much higher than that of ILECs, as shown in Table 10 and Table 11.

Figure 7 – Comparison of Residential and Business Telephony Services in Texas by Local Access Lines

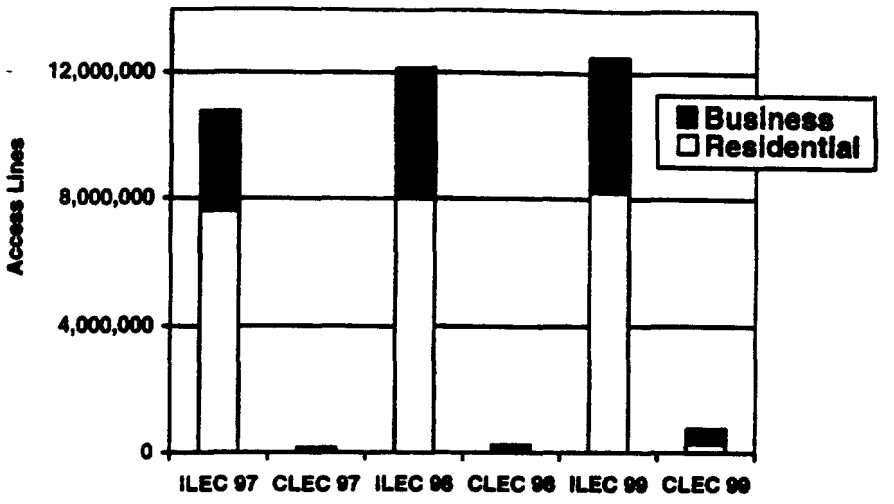


Table 8 – Residential Lines

	1997		1998		1999	
	Lines	%	Lines	%	Lines	%
ILEC	7,619,269	98.4	8,009,450	99.0	8,216,074	96.7
CLEC	122,450	1.6	79,114	1.0	280,826	3.3
Total	7,741,719		8,088,564		8,496,900	

Source: Public Utility Commission Data Request 2000 Responses

Table 9 – Business Lines

	1997		1998		1999	
	Lines	%	Lines	%	Lines	%
ILEC	3,147,904	99.3	4,125,663	96.1	4,315,929	89.7
CLEC	23,735	0.7	169,052	3.9	493,055	10.3
Total	3,171,639		4,294,715		4,808,984	

Source: Public Utility Commission Data Request 2000 Responses

Figure 8 – Comparison of Residential and Business Telephony Services in Texas by Revenues

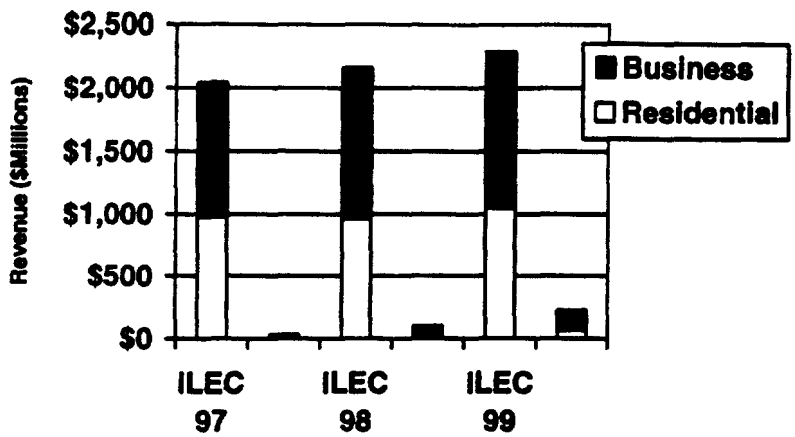


Table 10 – Residential Revenues

	1997		1998		1999	
	Revenue	%	Revenue	%	Revenue	%
ILEC	976,178,035	98.5	962,972,235	96.6	1,048,862,155	93.9
CLEC	14,375,823	1.5	34,019,358	3.4	67,632,535	6.1
Total	990,553,858		996,991,593		1,116,494,691	

Source: Public Utility Commission Data Request 2000 Responses

Table 11 – Business Revenues

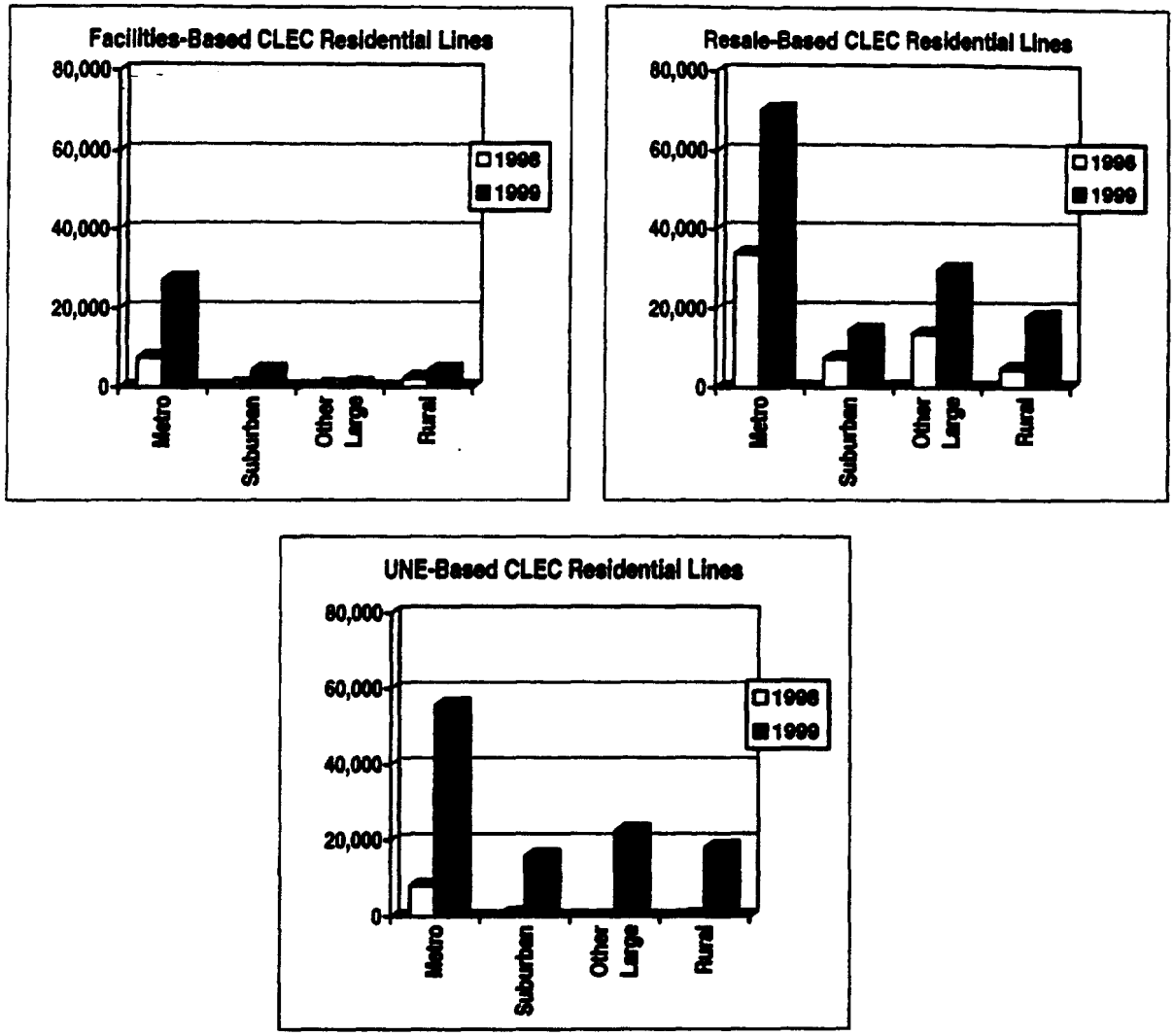
	1997		1998		1999	
	Revenue	%	Revenue	%	Revenue	%
ILEC	1,068,486,286	98.3	1,197,799,762	94.8	1,238,425,494	88.6
CLEC	18,359,970	1.7	65,344,881	5.2	159,694,131	11.4
Total	1,086,846,256		1,263,144,643		1,398,119,624	

Source: Public Utility Commission Data Request 2000 Responses

Facilities-based CLEC lines were almost exclusively in Large Metro areas. Eighty percent of all facilities-based CLEC lines in Texas served business customers in Large Metro areas, with another 10 percent serving Large Metro residential customers. Resale and UNEs were both popular outside Large Metro areas and with residential customers. See the charts and tables in Figure 9 and Figure 10.

The mix of business and residential customers varies significantly by population of a region. In Large Metro and Suburban areas, CLECs had 70 percent of their lines serving business customers and 30 percent of their lines serving residential customers. Medium and Small Metro areas of Texas saw a roughly 50-50 mix between business and residential lines. In Rural areas, CLECs served only 40,148 customers, with 30 percent of these being business customers and 70 percent being residential customers.

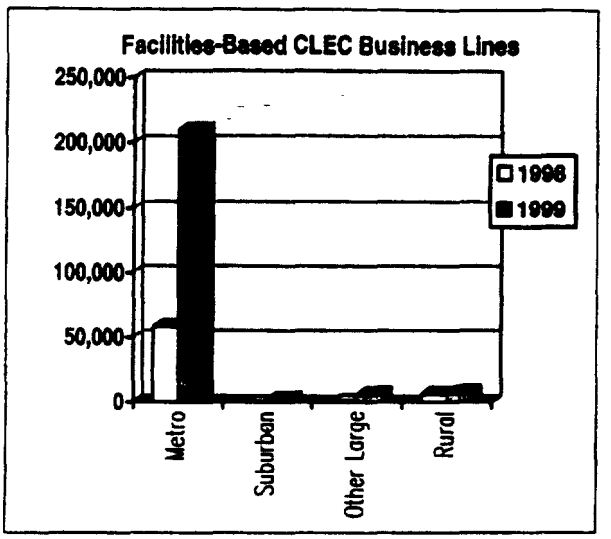
Figure 9 – CLEC Residential Lines by Provision Type and Region

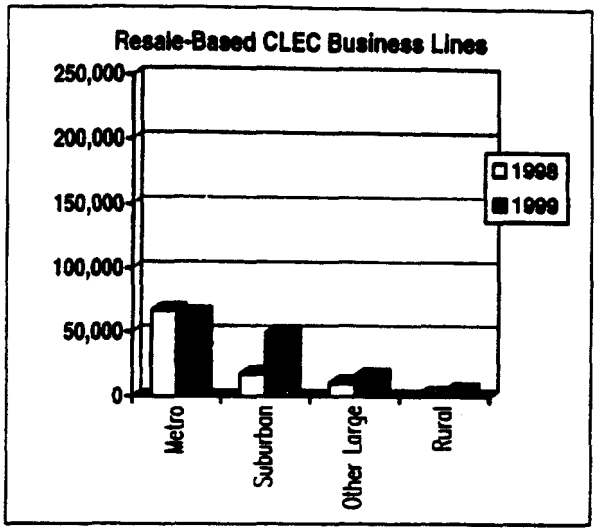


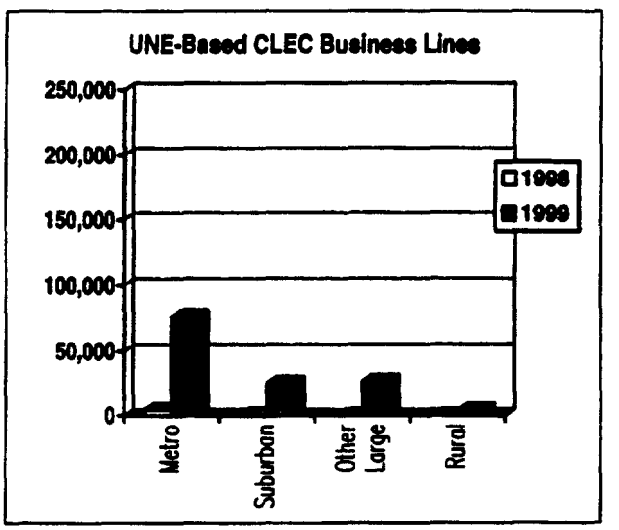
	Facilities		Resale		UNEs		Total	
	1998	1999	1998	1999	1998	1999	1998	1999
Residential – Lines								
Large Metro (Group 1)	7,509	27,052	33,822	70,101	8,067	55,737	49,398	152,890
Suburban (Group 2)	658	4,309	7,240	14,549	713	15,837	8,611	34,695
Small and Medium Metro (Group3)	480	750	13,604	29,758	6	22,585	14,090	53,093
Rural	2,216	4,267	4,600	17,899	199	17,962	7,015	40,148
Total	10,863	36,378	59,266	132,307	8,985	112,141	79,114	280,826

Source: Public Utility Commission Data Request 2000 Responses

Figure 10 – CLEC Business Lines by Provision Type and Region







	Facilities		Resale		UNEs		Total	
	1998	1999	1998	1999	1998	1999	1998	1999
Business - Lines								
Large Metro (Group 1)	58,303	209,837	67,427	64,324	4,793	76,290	130,523	350,451
Suburban (Group 2)	32	2,537	17,560	49,306	933	24,797	18,525	76,640
Small and Medium Metro (Group3)	1,020	6,252	10,377	16,239	4	26,351	11,401	48,842
Rural	6,108	7,403	2,281	5,155	214	4,564	8,603	17,122
Total	65,463	226,029	97,645	135,024	5,944	132,002	169,052	493,055

Source: Public Utility Commission Data Request 2000 Responses

Retail Prices and Cross Subsidies

In 1998 and 1999, the business sector attracted telecommunications competition at a far greater rate than the residential sector. Entrants, seeking the larger revenue streams, flocked into high subscriber-density areas rather than into low-density areas. This phenomenon, described by incumbents as "cream-skimming," is hardly surprising given the economics and the status of current telecommunications regulation.

Regulation tends to encourage "cream-skimming" by imposing cross-subsidies. The current retail rate structure contains implicit subsidies designed to achieve universal service. To subsidize basic services, regulators allow the telecommunications industry to assess a high mark-up on vertical services.[48] Business services typically have tariffed retail rates set at a much higher level than their costs to subsidize residential services. Urban customers tend to pay rates that are above cost, while rural customers tend to pay rates that are below cost.[49]

The practice of imposing cross-subsidies is incompatible with the goal of promoting fair competition (*i.e.*, based on real economic costs) via the construction of new facilities by new competitors. Cross subsidies also are inconsistent with fair competition via the purchase of UNEs, especially when the TELRIC-based pricing for UNEs is based on regional differences, rather than by customer class. Specifically, cross-subsidy regulation imposing retail prices inconsistent with the associated UNE rates encourages competitors into UNE-based "cream skimming" for services with overly high retail prices, and unduly discourages competitors from UNE-based provision for services that are under-priced.

In Texas, competitors can, under certain circumstances, take advantage of cross-subsidy regulation to offer service to business customers in high-density areas for a better rate than the ILEC can offer. The sum of TELRIC-based UNE rates for business services in urban areas is often less than the tariffed retail prices charged by the ILEC, which contain implicit subsidies for residential telephone service. Therefore, if a competitor's retailing costs plus the sum of UNE rates owed to the ILEC is below the ILEC's tariffed retail price, the competitor can turn a profit by purchasing a business phone's underlying UNEs, allowing it to offer various optional calling features at a total rate below the ILEC's retail price.[50] This opportunity is reinforced when the targeted customers spend relatively large amounts on long distance and other optional services without causing the competitor to incur substantial additional costs.

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[48] Actually, it is the flat-rated *access* to the telephone network (and hence to all services) via the customer's "local loop" that tends to be subsidized.

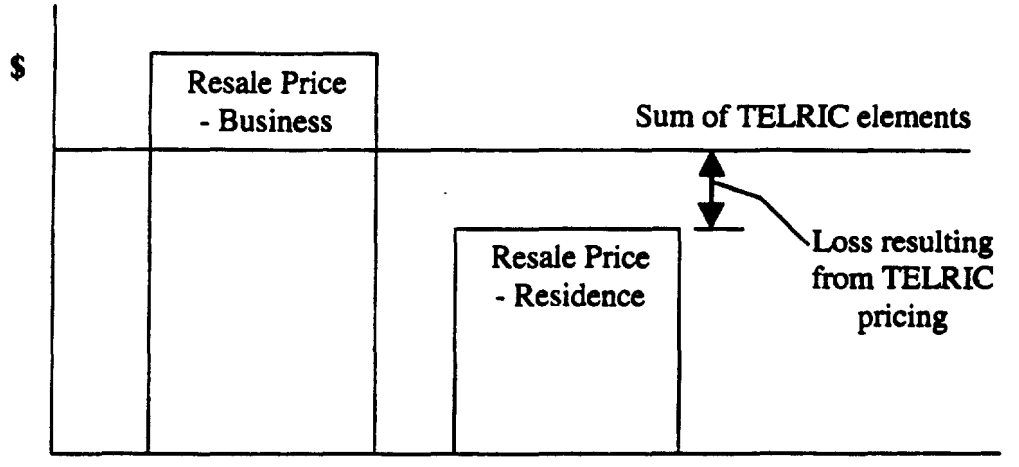
[49] Some of these cross-subsidies were diminished in the Commission's universal-service project (*Compliance Proceeding for Implementation of the Texas High Cost Universal Service Plan*, Project No. 18515), which provided for larger-scale, more systematic subsidies to providers serving customers in high-cost areas by means of a substantially increased Texas Universal Service Fund surcharge assessed on all taxable telecommunications receipts.

[50] David Sibley, Declaration for SWBT in *Interim Process for New Services and Promotional Offerings, and Pricing and Packaging Flexibility Tariffs, Pursuant to PURA Chapters 52, 58, and 59*, Project 20956, (Oct. 21, 1999).

On the other hand, providing services using UNEs to residential customers (at least those who use long-distance sparingly and purchase few if any optional services) may not be profitable for competitors because the revenue the competitors can recover from the retail rate could be below the sum of the UNE rates needed to provide such service. Consequently, competitors are much less likely to provide UNE-based service to such residential customers.[51]

This inconsistency of retail rates and UNE rates for residential and business is illustrated below.[52]

Figure 11 – TELRIC-based UNE Rates vs. Retail Rates



Long Distance Competition

Although Texans enjoyed a wide selection of long distance carriers (also known as interexchange carriers, or IXCs) at the end of 1999,[53] the long distance market continued to be dominated by three carriers: AT&T, WorldCom (which merged with MCI in September 1998), and Sprint. Economists refer to this phenomenon as a "tight oligopoly," meaning that the dominant competitors possess a level of market power that enables them to use significant discretion in setting prices. A market may be considered a "tight oligopoly'" if its four largest firms serve at least 60% of the market. In 1999, the

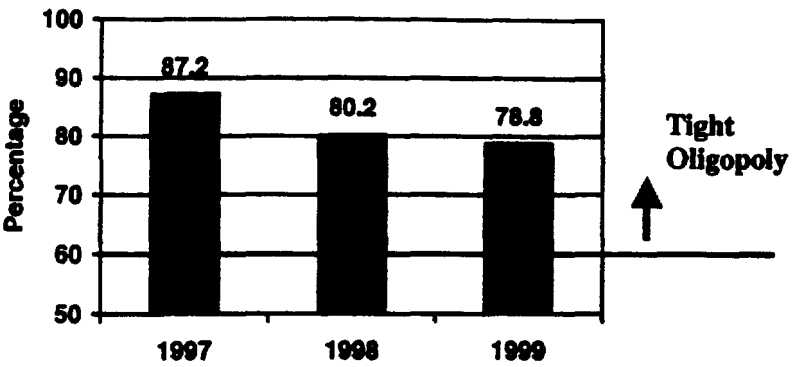
[51] The ability to resell the ILEC's services at a discount offers an additional avenue for competitors to provide service. The availability of universal-service subsidies for providing facilities- or UNE-based service to customers in high-cost areas also provides an incentive for competitors to serve some customers in less urbanized areas.

[52] David Sibley, Declaration for SWBT in *Interim Process for New Services and Promotional Offerings, and Pricing and Packaging Flexibility Tariffs, Pursuant to PURA Chapters 52, 58, and 59,* Project 20956, at 6 (Oct. 21, 1999).

[53] As of September 2000, 1550 long-distance carriers were registered with the Public Utility Commission of Texas. The commission's list of registered long-distance carriers can be found at http//www.puc.state.tx.us/telecomm/directories/ixc.xls.

market share in Texas of the largest three IXCs was 78.8% compared to 80.2% in 1997 and 87.2% in 1995 for the same three firms.[54]

Figure 12 – Long Distance Market Share of AT&T, WorldCom, and Sprint Combined



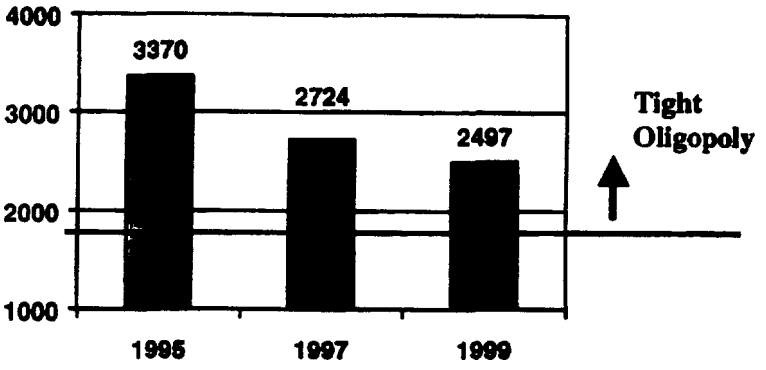
Another widely recognized measure of market power is the Hirschman-Herfindahl index (HHI).[55] This index ranges from a theoretical minimum of just above zero (meaning no firm has a meaningful market share) to a maximum of 10,000 (meaning a complete monopoly exists). An HHI at or above 1,800 indicates that a market is tightly oligopolistic, *i.e.*, highly concentrated. While the HHI was 3,370 in 1995 and 2,724 in 1997, it declined to 2,497 in 1999.[56] The last HHI suggests that the Texas intrastate long distance market was still highly concentrated at the start of 2000, though the market power of the three largest IXCs was continuing to decline.

[54] These market-share percentages are based on originating access minutes of use. The 1995 and 1997 percentages are for AT&T, MCI, Sprint, and Worldcom combined. The 1999 percentage is for AT&T, Worldcom and Sprint; Worldcom purchased MCI in 1998. Market share also may be measured using revenues, presubscribed lines, customers, or some other measure.

[55] The HHI is calculated by summing the squares of each firm's market share expressed as a percentage.

[56] These indices are actually lower-bound estimates, derived by adding the sums of the squares of the shares of the top four long-distance carriers in 1995 and 1997 and the top three in 1999. The 1999 estimate was calculated using only access minutes of use purchased from SWBT, Verizon, and the Sprint ILECs. Staff was not able to obtain data on an IXC-specific basis due to the reluctance of companies to provide company-specific data. The problem of obtaining data to calculate the HHI is discussed in Chapter 7 of this *Report*, under Legislative Recommendation No. 3 (*Clarify and Ensure Commission Authority to Protect proprietary Information*) as one of several examples of companies' refusal to provide information due to concerns about the Commission's ability to protect commercially sensitive information.

Figure 13 – Hirschman-Herfindahl Index (HHI) of Three Largest Long Distance Carriers (AT&T, WorldCom, and Sprint)



A significant change in the long distance arena occurred on July 10, 2000, when SWBT's affiliate SBC Long Distance entered the interLATA long distance market.[57] Unlike other long distance carriers, as of late 2000 SBC Long Distance offered interLATA long-distance service only to SWBT's local exchange telephone customers. Given SBC Long Distance's initial success in attracting long distance customers combined with customer enthusiasm for one-stop shopping, the erosion of the interLATA dominance of AT&T, WorldCom, and Sprint appears to be accelerating. As of December 5, 2000, SBC reported to the Commission that 1.2 million residential customers and more than 300,000 business customers had signed up for its interLATA long distance. The associated access line total represents more than 12% of SWBT's access lines in Texas.

As a result of a restructure of the Texas Universal Service Fund and the implementation of PURA § 58.301, *Switched Access Rate Reduction*, between September 1, 1999, and July 1, 2000, switched access rates charged to IXCs for originating and terminating long distance calls were reduced significantly. The reductions were flowed through to retail customers in the form of lower long distance rates. On average, a standard long distance call that previously was priced at $.15 - $.25 per minute of use was decreased to $.10 to $.20 per minute of use. Generally, long-distance rates charged by large IXCs were reduced by five cents ($.05) per minute of use. These reductions memorialized an important goal of the last legislative session – to make certain that retail customers benefited from significant reductions to access charges paid by IXCs.

Conclusion

CLECs entered Texas in large numbers, particularly in Dallas and Houston, which had over 40 CLECs by mid-2000, and in Austin and San Antonio, which each had nearly 30 CLECs. CLECs gained market share in local telephony, particularly in the Large Metro and Suburban areas of those four cities.

[57] SWBT's entry into the long distance market is discussed in detail in Chapter 2 of this Report.

CLECs had stronger market penetration among business customers than residential customers. CLECs entered Large Metro markets by building infrastructure and entered other regional markets by using a combination of resale of services and purchase of UNEs. Even rural areas of Texas were found to have multiple CLECs, but questions remain as to whether these CLECs serve a small niche market or the broader range of residential customers. Market penetration in rural areas overall was limited but increasing over time.

CHAPTER 4: COMPETITIVE DEVELOPMENTS IN 2000

The data in Chapter 3 show that, in 1998 and 1999, a number of well-financed CLECs appeared poised to provide ILECs with competition for local exchange service in large and Suburban markets in Texas and to slowly but steadily increase market share in Rural areas. In 2000, however, some CLECs fell on hard times, forcing some into bankruptcy, restructuring, and mergers. A number of these CLECs announced plans to reduce their efforts in local voice service in Texas. At the same time, SWBT strengthened its financial position relative to CLECs, gained substantial market share in long distance markets, and raised the prices of various non-competitive telecommunications services.

CLECs

CLECs entered Texas in large numbers in 1998 and 1999. A number of the startups were well financed, and the three largest long-distance carriers had announced their intentions to compete in local voice telephony in Texas. In the past year trends in the stock market and in the telecommunications industry have dramatically changed the dynamics of competition in local service.

FINANCIAL SIZE AND STRENGTH IN THE LATE 1990S

The financial size and strength of CLECs relative to ILECs can influence the quality and intensity of competition in local telephone service in various areas of Texas. While a large number of CLECs have entered the Texas market, if their capitalization is thin or if they are not affiliates or subsidiaries of well-capitalized firms, CLECs may not provide substantial competition to entrenched ILECs, particularly if financing for start-up firms proves difficult.

If a number of CLECs have deep pockets or are affiliates of companies with deep pockets, these firms can fight long and hard for market share if the prospects for solid profits are good. They would be in a position to finance the installation of lines, to purchase long-term contracts for UNEs, to market their services effectively, and to maintain a presence in a local market if the incumbent decided to undercut prices in an attempt to retain market share.

The survey reveals that by the end of 1999, 90 CLECs had entered the Texas market for local exchange service, as shown in Table 12.[58] The vast majority of CLECs

[58] Due to the Commission's limitations on acquiring competitively sensitive information, the number of CLECs actually providing service to paying customers at the end of 1999 is not known, and

were private companies. Of the remaining CLECs, the survey showed comparable numbers of telephone cooperatives and publicly traded firms.[59] These CLECs were competing with fifty-nine ILECs. Telephone cooperatives and small, private companies accounted for more than 80 percent of the ILECs.

Table 12 – Texas ILECs and CLECs by Type of Organization

	ILECs		CLECs	
Type of Entity	Number	Percent of Total	Number	Percent of Total
Public Companies	10	16.9%	10	11.1%
Private Companies	25	42.4%	72	80.0%
Telephone Cooperatives	24	40.7%	8	8.9%
Total	59	100.0%	90	100.0%

Source: Public Utility Commission Data Request 2000 Responses

Table 13 lists the CLECs by size of their capitalization, defined in this case as the value of debt and equity of the CLEC's parent in its most recent financial statement, which in most cases was year-end 1998 or year-end 1999.[60] Financial data on 52 CLECs were not available for this analysis. Most of these 52 CLECs were private companies, many of which do not publish their financial statements. Most of these firms likely were small with limited financial resources. They may have been niche players, gambling on quick, rapid growth, or eventually merging with another CLEC when the market consolidates.

therefore the percentage of those replying to the Commission's data request cannot be known. Several perspectives are available on the response rate to the Commission's data request and are detailed in Appendix H. Because it is nearly impossible for a CLEC to provide services without an interconnection agreement with an ILEC, the Commission believes that a critical mass of competitive providers submitted data, based on the 73 responses that were received from the 150 companies that had interconnection agreements in place by the end of 1999, which was the close of the period for which data were requested.

[59] One of the cooperatives, Denton Electric Cooperative, is an electric, not a telephone, cooperative.

[60] Staff in the Commission's Financial Review section made a determination of which subsidiary of a company was the parent based on financial statements and experience in the industry. Staff did not contact or ask the firm directly for this information, so the Commission does not claim that the identification of the parent companies is exact. Nor did staff make an attempt to determine the market capitalization of the publicly traded companies in this survey. Thus, the figures presented in this analysis should be considered illustrative rather than definitive.

Table 13 – Capitalization of CLECs: Debt and Equity Listed in Financial Statements

Size of CLEC	Number	Percent of Total
More than $10 billion	10	11.1%
$1 billion - $10 billion	11	12.2%
$100 million - $1 billion	7	7.8%
Less than $100 million	10	11.1%
Unknown	52	57.8%
Total	90	100.0%

Source: Public Utility Commission Data Request 2000 Responses

In 1999 the Texas market had CLECs with a wide range of capitalizations, some of which are very large electric or telephone utilities. Twenty-one firms, or a quarter of all CLECs, had parent companies with $1 billion or more. Almost 70 percent of all CLECs, however, had less than $100 million in capitalization or did not publish their financial information.

The two largest ILECs listed were SWBT and GTE/Verizon, ILECs subject to customer choice. These two ILECs each had capitalizations of over $10 billion, as shown in Table 14. Almost 90 percent of all ILECs in Texas, however, had capitalizations of less than $100 million. State and federal law and regulations allow small ILECs to forgo the implementation of standard interconnection agreements. This exemption hinders customer choice in many service areas of Rural Texas.

Table 14 – Capitalization of ILECs (Debt and Equity)

Size of ILEC	Number	Percent of Total
More than $10 billion	2	1.7%
$1 billion - $10 billion	1	3.4%
$100 million - $1 billion	3	5.1%
Less than $100 million	50	84.7%
Unknown	3	5.1%
Total	59	100.0%

Source: Public Utility Commission Data Request 2000 Responses

CLECs' Investment in Infrastructure

The flood of financial capital that CLECs had at their disposal in the late 1990s allowed them to be aggressive in investing in new plant and equipment in Texas in 1999, as shown in Table 15 and Table 16. While ILECs had considerable construction expenditures in the late 1990s, many of these expenditures appear to have been offset by depreciation of existing equipment. CLECs, in contrast, increased their construction expenditures in 1999 by more than three times their 1998 expenditures, accounting for

one out of every four dollars of new investment in 1999. As a result, CLECs' share of infrastructure, as measured by net plant investment, doubled in one year to nearly ten percent in 1999.

Table 15 – Net Plant Investment

	1998		1999	
	Net Plant Investment	%	Net Plant Investment	%
ILEC	13,678,746,833	95.0%	13,849,642,077	90.5%
CLEC	713,529,978	5.0%	1,457,917,966	9.5%
Total	14,392,276,810		15,307,560,043	

Source: Public Utility Commission Data Request 2000 Responses

Table 16 – Construction Expenditures

	1998		1999	
	Construction Expenditures	%	Construction Expenditures	%
ILEC	2,396,430,541	90.8%	2,282,189,742	74.0%
CLEC	243,005,792	9.2%	800,765,765	26.0%
Total	2,639,436,333		3,082,955,507	

CLECs also invested in switching offices, as shown in Figure 14. Growth was most rapid in switching offices serving 31,000 or fewer lines. Table 17 shows that CLECs doubled the number of switching offices that served over 300,000 lines from eight in 1998 to sixteen in 1999.

Figure 14 – Comparison of ILEC and CLEC Switching Offices

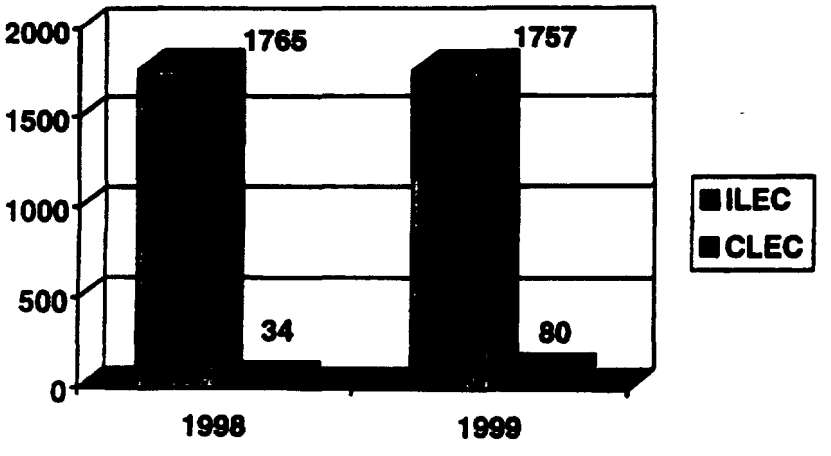


Table 17 – Comparison of Switching Offices by Size of Office

Size of Switching Office	1998		1999	
	ILEC	CLEC	ILEC	CLEC
Fewer than 3,000 Lines	928	17	914	45
3,000 to 31,000 Lines	360	8	363	16
31,000 to 100,000 Lines	100	1	103	1
100,000 to 300,000 Lines	42	0	42	2
Over 300,000 Lines	335	8	335	16
Total Switching Offices	1,765	34	1,757	80

Source: Public Utility Commission Data Request 2000 Responses

FINANCIAL STRUGGLES IN 2000

The capitalization of firms in 1998 and 1999, while consistent with the timeframe of the information in the data collection instrument, no longer presents an accurate picture of the financial condition of many CLECs.

The FTA and the increased market penetration of the Internet stimulated substantial investment in the telecommunications industry in the past two years. Capital spending by telecommunications companies in the United States is projected to exceed $100 billion in 2000, almost three times the level in 1995.[61]

According to analysts in the telecommunications industry, investment in telecommunications lines and equipment has greatly outpaced growth in revenues in 1999 and 2000. The American telecommunications industry had a negative cash flow of $20 billion in the first half of 2000, on top of a negative cash flow of $11 billion in 1999.[62]

The industry turned to capital markets to finance this investment, issuing tens of billions of dollars in stock and bonds. The telecommunications industry became a major source of investment funds. Since year-end 1998, slightly more than 50 percent, or about $10.3 billion of the $20 billion in private equity that firms poured into minority investments in public companies,, went to telecommunications firms. In 1998 and 1999, telecommunications companies issued over $50 billion in high-yield bonds.[63]

This sharp increase in investment has led to a boom and bust in share prices of CLECs. Table 18 shows the performance of the NASDAQ Telecommunications Index for the period January 1, 1998 to December 5, 2000. The index rose from 306.1 in December 31, 1997 to a peak of 1,230.1 on March 10, 2000. By early 2000 this rise in the stock market provided CLECs with large capitalizations.

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[61] "One Analyst's Grim Telecommunications View," *New York Times* (October 5, 2000).

[62] *Id.*

[63] "Telecom Sector Has Become a Black Hole for Investors," *Wall Street Journal* (October 13, 2000).

Table 18 – Performance of the NASDAQ Telecommunications Index (January 1, 1998 – December 5, 2000)

Date	NASDAQ Telecommunications Index	Increase from Previous Period	Cumulative Increase from December 31, 1997
December 5, 2000	534.4	-56.6%	74.3%
March 10, 2000	1,230.1	21.1%	301.2%
January 1, 2000	1,015.4	102.7%	231.2%
January 1, 1999	500.9	63.4%	63.4%
January 1, 1998	306.6	NA	NA

Source: National Association of Securities Dealers website, http://www.nasdaq.com, 10/31/00.

According to various reports in the financial press in the fall of 2000, investor sentiment turned sharply negative towards the telecommunications sector when CLECs were unable to convince investors that prevailing and projected profits were large enough to justify the prevailing level of investment and high share prices. In the nine months after its March 2000 peak, the NASDAQ Telecommunications Index fell 57 percent.

In the second half of 2000, CLECs found that access to capital, in the form of bank loans, issuance of debt, or initial public offerings of equity, was much more limited than it had been in the previous 18 months. The spread between telecom high-yield bonds and U.S. Treasuries (the safest debt instrument in the market) rose from 4.72 percent at the beginning of 2000 to 8.26 percent in mid-October, dramatically increasing the cost of raising venture capital for the typical small CLEC.[64]

The fall in the share prices of telecommunications companies strongly impacted some promising CLECs that had entered the Texas market. For example, four CLECs that once had a capitalization listed in Table 13 as $800 million or more in 1998 or 1999 – Covad, ICG, Rhythms, and Teligent - saw their share prices fall more than 95 percent from their 2000 peaks, as shown in Table 19. In contrast, the stock price of the leading ILEC in Texas, Southwestern Bell, was less than 10 percent off its peak in 2000.

[64] *Id.*

Table 19 – Fall in Share or Index Prices of Telecommunications Providers in 2000

Category	Peak Price in 2000	Price on December 5, 2000	Percent Change in Stock Price
NASDAQ Telecommunications Index	1,230.1	534.4	-56.6%
ILEC			
Southwestern Bell	59.0	53.4	-9.5%
Large CLECs which are Long-Distance Carriers			
AT&T	61.0	20.4	-66.6%
Sprint	67.0	23.9	-64.3%
Worldcom	51.9	14.7	-71.7%
Selected Small CLECs			
Allegiance	110.1	17.6	-84.0%
Covad	66.6	1.9	-97.1%
ICG	39.2	0.3	-99.2%
Rhythms	50.0	0.9	-98.2%
Teligent	100.0	3.5	-96.5%

Source: Yahoo! webpage, http://finance.yahoo.com; *Wall Street Journal*, December 5, 2000

Larger CLECs that are long distance carriers also faced a difficult set of problems in 2000. A significant change in the long distance arena occurred on July 10, 2000, when SWBT's affiliate SBC Long Distance entered the interLATA long distance market. Given SBC Long Distance's initial success in attracting long distance customers, combined with customer enthusiasm for one-stop shopping, the erosion of the interLATA dominance of AT&T, WorldCom, and Sprint appears to be accelerating.

By the end of October 2000, stock prices for the three largest long distance carriers fell by two-thirds from their calendar year 2000 highs. These events led long-distance carriers to reconsider their business strategies in the Texas local telephone market.

CLECs Reconsider the Texas Market

Table 20 presents a recent snapshot of the actions that key CLECs have taken with regards to the Texas local voice market. Some of these CLECs were the largest, most capitalized CLECs in the Texas in 1998 and 1999 and were considered the "shining examples" of competitors to Texas ILECs for residential customers in Texas

Table 20 – Changing Business Strategies for CLECs in the Texas Market

CLEC	Action Taken	Date Announced	Source
AT&T	Reduced presence in residential voice market, focusing on data services. Restructure/divestiture into four separate business.	10/25/00	att.com/press/item/ Seth Schiesel, "AT&T, In Pullback, Will Break Itself Into 4 Businesses," New York Times, 26, Oct. 2000. Floyd Norris, "AT&T Realigns Its Planets," *New York Times*, Oct. 26, 2000.
Sprint	Reduced presence in residential voice market, focusing on data services.	11/03/00 11/22/00	CNET News.com PUC Project No. 17475 filing: Non-Dominant Carrier Tariff revisions to Grandfather Optional Calling Plans and Extended Area Service - Sprint Local Unlimited and Global Pref.ed Extended
Worldcom	Reduced presence in residential voice market, focusing on data services.	11/01/00	2000 Test.newsbytes.com/news/00 "WorldCom to Reorganize, Focus on Internet, Data," *Dallas Morning News*, Oct. 27, 2000.
Verizon /VSSI	Amend to withdraw local service package. Reduced presence within residential voice market, focusing on data services. Withdrawal of bundled package offerings.	10/20/00 11/13/00	Vikas Bajaj, "Verizon to Close Division," *Dallas Morning News*, Oct. 20, 2000. *Application of Verizon Select Services, Inc., for an Amendment to its COA*, PUC Docket No. 23271.
Excel Communications	Intent to cease local exchange service within the Texas market.	11/20/00	Letter to Commission, Robin Johnson, Assistant General Counsel, Excel Communications.

Source: Public Utility Commission

Provided below are more details on the situations faced by the companies presented in Table 20.

AT&T

In October 2000, AT&T abandoned its ambitious but unprofitable business plan of the last three years in favor of splitting into three different companies: Wireless, Broadband (containing cable), and Business Services, which contains and will eventually spin-off Consumer Services. The Business Services division will own the AT&T name and network, while the other companies will lease the rights. AT&T's plan to deliver bundled local exchange, long distance, broadband internet, and cable television over coaxial cable lines is now defunct.[65]

AT&T is also spinning off Liberty Media, a cable programming company it acquired during its long buildup in preparation for the abandoned integrated cable services plan.[66] Some telecommunications analysts say that AT&T will eventually pull completely out of the local exchange market, which has produced lower revenues than

[65] Seth Schiesel, "For Local Phone Users, Choice Isn't An Option," *The New York Times*, at A1 (November 21, 2000).

[66] Geraldine Fabrikant, "AT&T Plans Spinoff to Cut Cable Holdings," *The New York Times* at C1 (November 16, 2000).

expected.[67] The company has also seen an 11% drop in its long distance earnings in 2000, down from $22 billion.[68] With a $62 billion debt and company stock down from a high of $61/share in 1999 to less than $20/share in November 2000, few financial analysts are predicting a quick recovery.[69]

AT&T plans to move its Consumer Services division into bundling voice and DSL, and recently appointed David Dorman, an executive with a history of taking over troubled companies, as its president. Dorman is expected to focus on maintaining quality in the Business and Consumer Services division.[70] Some analysts have alleged that bundling voice and data will not solve the company's problems, as it will not differentiate AT&T from the many other CLECs offering the same services.[71] However, in the era of deregulation, long distance does not hold the same place for AT&T as it has in the past. The BOCs are entering the market with a strong customer base. As described in Chapter Three, SWBT, in particular, has picked up over a million long distance customers in Texas since July, grabbing a 12% share of the long distance market while ceding very little of the local exchange market.[72]

Verizon

Like AT&T, Verizon is having difficulty in the competitive local exchange and long distance markets. Verizon fared better than some other major telecommunications companies, through better estimation of its profit expectations. However, local and long distance revenues are dropping for the company, which claims that data sales alone are keeping its profits aloft.[73]

Verizon's financial difficulties in the CLEC market have apparently led the company to attempt to pull out of the residential competitive local exchange market in Texas, where it services over 43,000 customers. Verizon's CLEC, VSSI, submitted an Application for Amendment to its COA in November 2000, stating its wish to "discontinue competitive local exchange services to consumers and small business customers in Southwestern Bell and former GTE service areas." The PUC is awaiting further information from Verizon, including any plans for transfer of current customers to similar plans on other local exchange carriers and a justification for retaining its COA.

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[67] Seth Schiesel, "For Local Phone Users, Choice Isn't An Option," *The New York Times*, at A1 (November 21, 2000).

[68] Deborah Solomon, "AT&T Plans Big Asset Sales to Cut Debt," *The Wall Street Journal*, at A3 (November 8, 2000).

[69] Peter Elstrom, "AT&T: Breaking Up Is Still Hard To Do," *Business Week*, at 173-174 (November 6, 2000).

[70] Deborah Solomon, "AT&T Names Telecom Veteran Dorman Head of Business, Consumer-Phone Units," *The Wall Street Journal*, at A3 (November 29, 2000).

[71] Elizabeth Starr Miller, "Consumers at the Core: AT&T to Keep Consumer Side Close to Home," *Telephony*, at 28 (October 30, 2000).

[72] Elizabeth Douglass, "Firms Giving Long-Distance Short Shrift," *The L.A. Times* (November 8, 2000), accessed via Internet, www.latimes.com.

[73] Shawn Young, "Verizon Reports Solid Results Amid Sales Growth," *The Wall Street Journal*, at B10 (October 31, 2000).

MCI WorldCom

Immediately following AT&T's split announcement, WorldCom revealed that it also will spin off its local exchange and long distance services, most of which it acquired when it merged with MCI Communications in 1998, into a separate tracking stock under the MCI name.[74] As with AT&T, some analysts contend that this is the beginning of a shift away from local service.[75] WorldCom's stock is down 75% from its 1999 peak, proportionally more than AT&T's loss.[76]

WorldCom CEO Bernard Ebbers had long presented the company as an upstart intent on taking AT&T's business, but some analysts contend that Ebbers structured his company so similarly to AT&T that he was caught in the same downdraft in long distance revenues.[77] To illustrate the cutthroat nature of the long distance environment, Ebbers described a situation in which, after MCI won a big contract for Kmart's communication business, AT&T CEO C. Michael Armstrong called Kmart and offered them service for $5 million less than WorldCom's bid, regardless of what it was. Ebbers then offered Kmart service for $2 million below AT&T's offer, which would have been, by his admission, less than profitable. AT&T lowered its bid again and won the contract.[78]

WorldCom's push towards data is evidenced in its recent acquisition of Intermedia, a leading data provider, only a few weeks after announcing the MCI spin-off. WorldCom also recently began providing high-speed internet access in Memphis through fixed wireless technology.

Sprint

Sprint profits have been steady lately, mostly due to packaging long distance with data.[79] Sprint's CLEC offers local exchange service in 21 markets throughout the nation and has announced plans to enter 80 more over the next year, mostly using fixed wireless technology.[80] Sprint is de-emphasizing traditional local exchange, however, except as part of a package.[81]

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[74] Seth Schiesel, "With WorldCom's Breakup Plan, Eerie Similarities to AT&T," *The New York Times*, at C1 (November 2, 2000).

[75] Elizabeth Douglass, "Firms Giving Long-Distance Short Shrift," *The L.A. Times* (November 8, 2000), accessed via Internet, www.latimes.com.

[76] "WorldCom's Bernie Ebbers Scrambles to Raise Cash," *The New York Times*, at C1 (November 11, 2000).

[77] Seth Schiesel, "With WorldCom's Breakup Plan, Eerie Similarities to AT&T," *The New York Times*, at C1 (November 2, 2000).

[78] David Henry and Michelle Kessler, "Competition Grows Fierce," *USA Today* (November 2, 2000), accessed via Internet, www.usatoday.com.

[79] Bruce Meyerson, "Sprint Will Not Spin Off Long-Distance," *Austin American-Statesman*, at G4 (November 4, 2000).

[80] Paul Davidson, "Competition Squeezes Out Traditional Firms," *USA Today* (November 3, 2000), accessed via Internet, www.usatoday.com.

[81] Bruce Meyerson, "Sprint Will Not Spin Off Long-Distance," *Austin American-Statesman*, at G4 (November 4, 2000).

This de-emphasis of local exchange has led the company's CLEC to cease offering residential local exchange service to new customers in Texas, as of November 27, 2000. Existing customers have been grandfathered in their service, but are not allowed to change any features or add lines at the risk of termination of service.

In October, Sprint announced plans to offer its ION (meaning "integrated on-demand") service to residential customers in Houston and Dallas. ION bundles up to four voice lines, 750 minutes of long distance, vertical telephone services, and high-speed internet access. It is unclear whether, in light of Sprint's CLEC's decision to quit offering residential local exchange service, the company will follow through with this announcement. Sprint claims that the service would cost between $120 and $150, and has been available to business customers in Dallas since June.

Excel Communications

Excel Communications is a CLEC focused mostly on long distance, wireless, and internet access, although the company has been offering voice in some areas of Texas. However, like Sprint and Verizon, Excel has just announced its intent to cease local exchange service in Texas, citing the difficulty of breaking into the CLEC market in Texas and concerns about the short-term profitability.

TXU / Fort Bend Communications and Reliant Communications

These two companies had some of the deepest pockets among CLECs, as well as electric industry parents with a strong local presence and name recognition in Dallas and Houston, two markets where CLECs had been building wireline infrastructure. These advantages were not sufficient to challenge SWBT in local service. Reliant Communications has announced that it is abandoning voice service to focus on data services. TXU / Fort Bend Communications has announced that it will limit its presence in the residential voice market to the more upscale and Suburban markets in Texas. By reducing its presence in residential voice markets, the company could focus on providing data services.

ILECs

In the past two years, ILECs have used the pricing flexibility and bundling of services that they gained in SB560 to try to retain customers. SWBT has raised prices on a variety of services that competitors do not provide.

SB 560 and Pricing Flexibility

SB 560 provided ILECs with pricing and packaging flexibility for a variety of nonbasic services to allow customers to buy a bundled product of services from one provider, also known as one-stop shopping. Through one-stop shopping, a customer can often obtain a lower price for a package of bundled services, can eliminate any aggravation associated with having multiple providers, and can consolidate multiple service charges onto one bill for billing ease. Because one-stop shopping has become

popular in recent years, ILECs and their competitors are aggressively bundling services together in various packages that appeal to customers, particularly in urban areas.[82]

ILECs, primarily SWBT and Verizon (GTE/Contel), exercised their pricing flexibility options in various ways, filing approximately 150 pricing flexibility tariffs since September 1999.[83] SWBT, in particular, offered dozens of promotions on vertical services (such as call return, Caller ID, call waiting, and speed calling) and toll services by waiving non-recurring installation charges, providing cash-back offers for customers who retain service for a minimum period, and through other incentives.

These ILECs packaged popular vertical services and toll services together in different ways that allow customers to obtain a bundle of services at a lower overall price. In September of 1999, for example, SWBT reduced prices for some toll packages, business call-management service packages, residential single-line packages, and government contracts for business lines in a range of approximately 5% to 30%. SWBT also exercised its ability to offer customer-specific pricing on many services, including long-distance services, certain high-speed digital private line services, and governmental services. By agreeing to obtain service for a fixed term, usually 1-5 years, business telephone customers benefit from lower rates offered through customer-specific contracts.[84]

Over the same period SWBT also lowered the prices of some individual services, to better compete with offerings from other providers, as shown in Table 21. For example, SWBT reduced the prices for (1) its Personalized Ring and Priority Call services by 13% to 33%; (2) its Plexar I and II offerings (central-office-based PBX-type services) by 1% to 14% in 1999, and various Plexar II ancillary features by 14% to 50% (involving decreases ranging from $.10 to $2.50) in 2000; and (3) its shorter-term digital private-line contracts (month-to-month and 1-3 years) by 6% to 22% on average. Of these, the Plexar and private line offerings are available to business customers only.

On the other hand, SWBT has significantly increased the prices for a number of nonbasic services, often services that are very popular and for which competitive alternatives are very limited. In September of 1999, SWBT raised prices on some of its

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[82] ILECs may offer their customers the following: local exchange telephone service, custom calling features and vertical services, hardware to support custom calling features and vertical services (such as the Caller ID unit that identifies a calling number), long distance service, internet service, voice messaging services and other enhanced services, cellular telephone service, high-speed private line service, digital subscriber line (DSL) service, and other services.

[83] From September 1999 through October 2000, if price increases and decreases, new services, and promotions are included in the mix, the number exceeds 175.

[84] PURA §58.003(a) prohibits some customer-specific contracts until 2003, specifically those applying to a narrow range of services offered by Chapter 58 companies, primarily for the basic local lines of business and residential customers. A Chapter 58 company can offer customer-specific pricing for most of its other services, including many vertical services and toll services. For example, SWBT's tariff currently permits SWBT to enter into customer-specific contracts with residential or business customers for any long-distance service it offers. Also, high-speed private lines are routinely offered on a customer-specific contract basis. Generally, business customers are more likely to find the long-term contracts attractive than are residential customers.

more popular business call-management services[85] in a range of approximately 6% to 42%. In November of 1999, SWBT increased the price of a business extra directory listing by 107%, from $1.45 to $3.00.[86] In June of 2000, SWBT increased its monthly rates for residential Caller ID services (caller ID name-or-number and caller ID name-and-number, both of which are very popular in Texas) in a range of 22% to 30%.[87] SWBT also raised the following rates: (1) for per-use three-way calling, from $.75 to $.95, with the $6.00 monthly cap eliminated; (2) for call return, from $.50 to $.95 per use, while eliminating the $4.00 monthly cap; and (3) for residential call blocker and residential auto redial, from $2.00 to $3.00 each per month. In late 2000, SWBT raised its analog private-line rates by an average of 15%. SWBT also recently proposed a large increase to its charge for *not* publishing a directory listing ("unlisted numbers"). Over the past two years, the price of individual vertical services tended to rise, making the package prices more attractive to customers.

Recently, the Commission established its threshold policy concerning packaging services for sale on a wholesale basis. Responding to a complaint filed by AT&T regarding SWBT's essential office package for business customers, the commission determined that an ILEC may not tie the sale of vertical services with the purchase of basic services on a wholesale basis. The Commission determined that such a pricing mechanism is presumptively an unreasonable restriction on resale that is prohibited by PURA and the FTA.[88]

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[85] Examples are three-way calling, anonymous call rejection, auto redial, call waiting, call waiting ID, and call forwarding. (The price for residential call forwarding, newly classified by SB 560 as a basic network service, has not been raised.)

[86] *Informational Filing of Southwestern Bell Telephone Company Pricing Flexibility Associated with Business Extra Listings, Pursuant to PURA § 58.15*, Tariff Control No. 21692 (November 19, 1999).

[87] *Informational Notice of SWBT for Pricing Flexibility Residence and Business Call Management (Vertical) Services; Pursuant to PURA § 58.063 and § 58.152*, Tariff Control No. 22719 (June 27, 2000).

[88] *Complaint of AT&T Communications of the Southwest, Inc. regarding Tariff Control Number 21311, Price Flexibility-Essential Office Packages*, Docket No. 21425, Final Order (December 19, 2000).

Table 21 – SWBT Price Changes Made Under SB 560†

Service	Description	Residential Prices			Business Prices	
		Old	New	Change	Old	New
Three Way Calling	Allows "on hold" & "add on" capability via switch hook	$2.10 for first, and $1.40 per additional of these services	$3.00 for first, and $2.00 per additional of these services	↑ ↑	$2.50	$4.00
Call Forwarding	Permits transfer of incoming calls to another phone no.			↑ ↑	$3.50	$6.00
Speed Calling 8	Permits speed dialing for up to eight programmed numbers			↓	$2.50	$1.50
Anonymous call rejection	Permits automatic rejection of anonymous incoming calls via Caller ID	$1.00	$1.00	= ↑	$1.00	$2.00
Auto Redial	Rings a called busy number when available	$2.00	$3.00	↑ ↑	$3.50	$4.00
Call Waiting	Indicates an incoming call while on the line	$2.80	$2.80	= ↑	$3.25	$5.00
Call Waiting ID	Identifies name and/or number of incoming call while on line	$3.00	$3.00	= ↑	$3.00	$5.00
Caller ID Name or Caller ID Number	Shows Name or Number of Incoming Caller	$4.95	$6.50	↑ ↑	$7.50	$8.00
Call Blocker	Blocks incoming calls from designated numbers	$2.00	$3.00	↑ ↑	$3.00	$3.50
Speed 30	Permits speed dialing for up to 30 programmed numbers	NA	NA	↓ ↓	$3.20	$2.00
Priority Call	Provides distinctive ring on calls from designated numbers	$2.50	$2.00	↓ ↓	$3.00	$2.00
Personalized Ring I	Distinctive ring for an additional number on same access line	$4.00	$3.50	↓ ↓	$6.00	$5.00
Call Return	Rings most recent calling number by dialing *69	$.50 each, $4.00 cap	$.95 each (no cap)	↑ ↑	$.50 each $4.00 cap	$.95 each (no cap)
Three Way Calling, per use	Allows "on hold" and "add on" capabilities via switch hook	$.75	$.95	↑ ↑	$.75	$.95
Call Trace, per Activation	Traces last incoming call, via activation before next call received	$8.00	$7.00	↓ ↓	$8.00	$7.00
Directory Assistance – Direct Dialed	Provides directory assistance via calling 1-411; call allowances not affected	$.30 per use	$.75 per use on local calls	↑ ↑	$.30 per use	$.75 per use on local calls
Directory Assistance Call Completion – Direct	Connects caller to number obtained when dialing directory assistance	$.30 per use	$.05 per use	↓ ↓	$.30 per use	$.05 per use

† Old and New compares prices from August1999 through December 2000

Source: SWBT filings

PRICING AND PACKAGING COMPARISONS AMONG PROVIDERS

Basic Service Charges

For a residential customer desiring only basic local service with no additional services (such as call waiting, call forwarding, caller ID, etc.), the minimum rates offered by the leading companies are shown in Table 22 below. Except for SWBT, most telecommunications companies do not package special long distance rates for customers seeking minimum basic service.

All cost figures are subject to fees, taxes, and surcharges, and may vary slightly among areas. Long distance packages are extra unless noted otherwise.

Table 22 – Minimum Rates for Basic Local Residential Service

Company	SW Bell	Sprint (ILEC)	AT&T	MCI
Dial Tone	X	X	X	X
Other	Optional long distance at $0.09/minute	some additional services may be available at no charge		
Cost per Month	$12-$16*	$11-$16.75*	$15	$7.75-$10.50

*Includes Subscriber Line Charge, may include mandatory Extended Area Service and Expanded Local Calling Service
Source: Public Utility Commission, Survey of company offerings as of November 28, 2000

Residential Package Comparison

Some residential customers hope to save money on local service, vertical services, and long distance through packages, which telephone companies are happy to offer to win more customers in the residential market. Table 23 shows some of the service packages offered by major telephone companies. The SWBT plan integrates many vertical services with local exchange service and a long distance plan. Sprint offers two packages, one with a set long distance plan and one that allows access to any of its pre-established long distance plans. AT&T offers a fixed long distance plan with customer choice in the number and type of vertical services. The MCI Worldcom packages offer permutations on local service combined with customer choice in different long distance plans and optional vertical services.

All packages are subject to service limitations and may not be available in all areas. All cost figures are subject to fees, taxes, and surcharges, and may vary slightly among areas.